New Regulations Are Needed to Take Full Advantage of the Opportunities Offered by Filing Large Corporate Income Tax Returns Electronically

May 2003

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

May 30, 2003

MEMORANDUM FOR COMMISSIONER EVERSON

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – New Regulations Are Needed to Take Full Advantage of the Opportunities Offered by Filing Large Corporate Income Tax Returns Electronically (Audit # 200230005)

This report presents the results of our review of the planned electronic filing system for large corporate income tax returns. Our objectives were to assess (1) the benefits of implementing an electronic filing system for large corporate taxpayers, (2) the Internal Revenue Service's (IRS) progress towards overcoming barriers to allow large corporate taxpayers to file electronically, and (3) the implications to the IRS if the system is not successfully implemented.

In summary, the IRS may never be able to significantly improve its services and operations devoted to large corporations unless it is able to take full advantage of the efficiencies offered by electronic filing. Despite positive organizational changes and reengineered business processes, without electronic filing, a wide gap will likely remain between large corporate taxpayer expectations for efficient, modern service and the IRS' performance. While the planned electronic filing system for corporations is poised to close this gap and deliver other more modest benefits, such as reduced return processing and storage costs, a significant barrier needs to be addressed. Specifically, there are no guarantees that the system will be used once it is available, which could be a major barrier to achieving the efficiencies offered by electronic filing.

To take advantage of electronic processing efficiencies and maximize the return on the over $33 million investment in the electronic filing system, we recommended that the Commissioner, Large and Mid-Size Business (LMSB) Division, initiate the actions needed to require large corporate taxpayers to file electronically. To realize benefits similar to those in the LMSB Division, we recommended that the Commissioner, Small

Business/Self-Employed (SB/SE) Division, perform a study to determine the costs and benefits of mandatory electronic filing for SB/SE corporations.

Management's Response: IRS management agreed with the recommendations presented in the report. The Commissioner, LMSB Division, will consult with the Office of Chief Counsel and the Department of the Treasury to evaluate the feasibility and impact of legally mandating corporate electronic filing. The SB/SE Division will study the feasibility of mandating electronic filing of its corporate tax returns. This study will include an internal cost/benefit analysis and external stakeholder input. Management did not agree with the outcome measures in Appendix IV without an assessment of the impact of electronic filing on corporate returns (Forms 1120 and 1120S), believing it is impossible to state the monetary benefits until they have the opportunity to analyze a sample of corporate electronic returns. Management's complete response to the draft report is included as Appendix V.

Copies of this report are being sent to the IRS managers who are affected by the recommendations. Please contact me at (202) 622-6510 if you have questions or Richard Dagliolo, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs), at (631) 654-6028.

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Background

The Congress recognized in the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98)[1] that the IRS' ability to effectively administer the nation's tax system largely depends on how successful it is in converting to an electronic environment and reducing its reliance on paper. The RRA 98 provides that the IRS should develop and implement a plan to have at least 80 percent of all Federal tax returns filed electronically by 2007. The RRA 98 also stipulates that, to the extent possible, all returns prepared on a computer should be filed electronically by 2003. To support the agency-wide effort in meeting the RRA 98 and to meet its future business vision of greatly improving services and operations devoted to large corporations, the IRS' Large and Mid-Size Business (LMSB) Division[2] is spearheading the effort to implement an 1120[3] electronic filing (*e-file*) system.

The 1120 *e-file* system the IRS is developing will accept corporate income tax returns filed by both small and large corporations. In 2002, the IRS received approximately 5.5 million Forms 1120 and U.S. Income Tax Returns for S Corporations (Form 1120S). The IRS' Small Business/Self-Employed (SB/SE) Division serves approximately 5.4 million corporations[4] and the LMSB Division serves approximately 76,000 corporations that file Forms 1120 and Forms 1120S. While the approximately 76,000 large corporations served by the LMSB Division are minimal when compared to other return types, the over $33 million and 5-year time investment to achieve 1120 *e-filing* is pivotal to the LMSB Division's strategy to address

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[1] IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).
[2] The LMSB Division serves corporations, sub-chapter S corporations, and partnerships with assets of $10 million or more.
[3] 1120 refers to the U.S. Corporation Income Tax Return (Form 1120) that corporations file with the IRS annually.
[4] The SB/SE Division serves about 45 million taxpayers. These taxpayers include fully or partially self-employed individuals and small businesses. The corporations, sub-chapter S corporations, and partnerships served by the SB/SE Division have assets less than $10 million.

corporate compliance issues and reduce taxpayer burden. If implemented as envisioned, the 1120 *e-file* system will change the way the IRS receives, processes, stores, and retrieves information needed to provide customer service and will enhance the IRS' ability to identify strategic compliance issues, trends, and problems for corporate taxpayers.

The 1120 *e-file* project is part of a much larger effort to modernize IRS computer systems. This larger effort, known as the Business Systems Modernization (BSM), receives funding from a special account established by the Congress called the Information Technology Investment Account. The 1120 *e-file* system funding decisions are not made by the LMSB Division; therefore, we did not include funding issues in the scope of our audit.

Like other BSM projects, the original 1120 *e-file* system requirements have changed to better meet the needs of the systems users and to take advantage of new technologies. The original blueprint called for modifying the system that the IRS currently uses to receive individual tax returns electronically so it would accept corporate returns. However, the MITRE Corporation[5] recommended building a new system that could take advantage of Extensible Markup Language. As a result, the 1120 *e-file* system is now expected to cost in excess of $33 million by the time it is fully implemented in 2005. This is considerably more than the original cost estimate of $8.5 million and a year later than the originally planned implementation date. One of the advantages of the 1120 *e-file* development is that it will form the basis for the next generation of electronic returns, including the 1040[6] *e-file* system.

To meet our objectives, we relied on the IRS' internal management reports, but did not establish the reliability of the data in them because extensive data validation tests were outside the scope of this audit. Aside from this one

[5] MITRE is a not-for-profit corporation that provides the IRS with independent, expert, and objective advice and guidance on strategic, technical, and program management issues.
[6] 1040 refers to the U.S. Individual Income Tax Return (Form 1040).

exception, our work was conducted in accordance with *Government Auditing Standards* between November 2001 and November 2002 at the LMSB Division Headquarters in Washington, D.C. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Significant Actions Have Been Taken to Overcome Barriers That Could Hamper the Success of Electronic Filing for Large Corporations

Positive organizational changes and reengineered business processes have removed barriers that could hamper the success of the 1120 *e-file* project. According to the General Accounting Office (GAO)[7] and others, before implementing information technology projects such as the 1120 *e-file* project, organizations almost always need to redesign or reengineer critical work processes. Otherwise, organizations risk encountering significant barriers to achieving desired improvements and wasting millions of dollars implementing information technology solutions that automate existing inefficient processes.

Although important work remains, the approach the IRS is taking to implement the 1120 *e-file* system follows the lead other organizations have used in successfully leveraging technology to gain significant long-term benefits. In response to the RRA 98 and taxpayer demands to address long-standing problems, the IRS began analyzing how to modernize operations by revamping business processes and practices. At issue for large corporate taxpayers were the problems of extensive time lags between filing a tax return and resolving tax issues, and the need to reduce the number of examinations that resulted in a "no change."[8]

Since the implementation of the RRA 98, many changes have been made to address these problems. In 2000, the IRS developed a vision that called for organizational,

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[7] See GAO reports entitled *Reengineering: Opportunities to Improve* (GAO/AIMD-95-67R, dated January 1995) and *Executive Guide: Improving Mission Performance Through Strategic Information Management and Technology* (GAO/AIMD-94-115, dated May 1994).
[8] "No change" examinations as discussed in this report refer to examinations that are closed without any recommended adjustments to income tax return items.

operational, and technological changes affecting the way it provides service and ensures compliance for large corporations. Simply put, the vision calls for:

- Making taxpayer interactions less difficult, less time-consuming, less expensive, and less contentious.
- Ensuring compliance and achieving increased efficiencies in examinations.

Organizationally, an important first step towards achieving the vision was establishing the LMSB Division and structuring it along five major industry segments. The change was intended to foster a closer working relationship between the Division and corporations to ensure timely examinations.

Since we reported[9] on the successful "stand-up"[10] of the LMSB Division in Fiscal Year (FY) 2000, Division officials have focused attention on assessing and making needed changes to critical work processes at the operational level. Several new strategies and initiatives are being developed, tested, and implemented to address decades-old problems, such as lengthy examinations and the high number of examinations that result in a no change.

For example, the Pre-Filing Agreement (PFA) Program[11] allows taxpayers to request examination of specific issues relating to a tax return before it is filed. The PFA process can resolve some tax issues more effectively and efficiently than a post-filing examination because the taxpayer and the IRS have more timely access to the relevant records and personnel. The PFA can also shorten post-filing

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[9] *Management Advisory Report: The Large and Mid-Size Business Division Substantially Accomplished Organizational Stand-Up* (Reference Number 2000-30-144, dated September 2000).

[10] Stand-up is a term that means a new function has the minimum requirements for operating, such as having key management positions filled and ensuring business authorities are in place.

[11] See audit report titled, *The Pre-Filing Agreement Pilot Project Was Successful, But Faces Challenges in Converting to an Operational Program* (Reference Number 2001-30-125, dated August 2001).

examinations because there will be fewer issues left to examine.

In another effort to improve compliance and reduce taxpayer burden, the LMSB Division is emphasizing that examiners focus on specific material issues, such as abusive tax shelters, rather than examining the whole tax return.[12] Abusive corporate tax shelters cost the Federal Government billions of dollars in taxes and have been identified as the highest compliance risk.

The Division is also testing statistical models under the Discriminant Analysis System (DAS). The objective of the DAS project is to prioritize returns for examination based on the probability that an examination would detect tax liability changes. Table 1 provides a brief description of other new strategies and initiatives in the LMSB Division.

Table 1: New LMSB Division Strategies and Initiatives

Strategies/Initiatives	Description
Issue Management Strategy	A group of initiatives focused on early issue resolution.
Compliance Risk Strategy	A group of initiatives aimed at ensuring the most productive returns are examined.
Information Document Request Management Process	A process for obtaining complete, timely information during examinations.
Fast Track Dispute Resolution Program	An opportunity for taxpayers to appeal issues earlier in the dispute resolution process.
Risk Analysis Process	A process focused on shortening examinations by targeting high-risk issues.
Industry Issue Resolution Program	A program that resolves, other than through an examination, contentious issues affecting a large number of taxpayers.

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of IRS data.

[12] The new Limited Issue Focused Examination process is an alternative to the traditional broad-based examination process, where examiners use risk analysis and materiality considerations to limit the examination to a few critical issues on a tax return.

Changed business practices by the LMSB Division have been well received by large corporate taxpayers. However, the overall problems of extensive time lags between filing a tax return and closing all the issues on an examination, and the need to reduce the number of examinations that result in a no change will likely remain a problem until a technical solution is implemented. The 1120 *e-file* system provides large corporate taxpayers and the IRS with the technical solution to address these decades-old problems.

Electronic Filing Is Poised to Reduce Lengthy Examinations and Deliver Other Benefits

According to IRS data and a December 2001 report prepared by a national consulting firm[13] for the IRS, use of an 1120 *e-file* system could eventually reduce the estimated $13.6 million spent annually to process and store paper returns for both large and small corporations. The 1120 *e-file* system will also provide the IRS a more accurate return and thus reduce the need for correspondence between the IRS and corporate taxpayers to correct transcription and similar types of errors identified during processing. However, these are modest benefits compared to the opportunity electronic filing offers for reducing the time span from when returns are filed until issues are resolved and for minimizing the number of examinations that result in a no change.

Electronic filing has significant potential to reduce lengthy examination cycle time

The IRS began studying large corporate examinations in the 1970s and on the basis of these studies announced numerous changes to its examination processes in July 1990. Some changes were intended to substantially improve the timeliness of examinations. However, reducing the length of large corporate examinations remains a challenge despite the 1990 changes and the IRS' long-standing policy[14] of striving to complete examinations in a timely manner.

The LMSB Division divides corporate examinations into Industry Cases (IC) and Coordinated Industry Cases (CIC).

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[13] *Large and Mid-Sized Business 1120/1120S Electronic Filing* (Booz-Allen & Hamilton, December 2001).
[14] Policy 4-52 that was approved in 1959 established an 18-month period for completing most examinations.

The IC corporate examinations are generally assigned to one examiner while CIC corporate examinations are conducted by teams of examiners. In FY 2002, IC and CIC corporate examinations averaged 35 and 60 months, respectively, from the time the returns were filed until the cases were closed (this is known as cycle time). LMSB Division officials indicated that they would have liked to see IC cycle time be within 31 months and CIC cycle time be within 57 months. Likewise, corporate taxpayers have also expressed dissatisfaction with the examination process. In testimony before the IRS Oversight Board in January 2002, the president of the Tax Executives Institute (TEI)[15] stated in part that:

> *Some of the most significant burdens imposed on taxpayers relate to the requirement that extensive records be maintained in respect of taxable years subject to audit. Although taxpayers clearly have a responsibility to maintain records to support positions taken on their tax returns, much can be done to minimize the burden that currently exists (especially for those taxpayers that have many years open for IRS examinations). Record retention burdens can best be reduced by increasing the currency of audits; if taxable years are closed in a more timely manner, there will be less need to retain records relating to those years.*

One of the primary reasons IRS officials have not been more successful in reducing the length of large corporate examinations is the labor-intensive system used to process corporate returns. Before a return is available for examination, current procedures for processing paper corporate returns can take as long as 20 months.

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[15] The TEI is an association of corporate and other business executives responsible for the tax affairs of their organizations. TEI members represent approximately 2,800 businesses in the United States, Canada, and Europe.

Today, all large corporate returns are initially received and processed in the IRS Submission Processing Site in Ogden, Utah. Upon receipt in the Site, IRS personnel:

1. Separate the returns with payments attached from those with no payment attached and ensure checks are deposited.
2. Check each return for completeness, code for data entry, and control each return with a unique 14-digit number.
3. Enter selected data into the IRS computers so they can be posted to taxpayer accounts.
4. File the returns so they can be forwarded to the IRS Statistics of Income (SOI) Division upon request. Once in the SOI Division, all the information on all the returns is input into databases and eventually used by governmental and private entities for analytical purposes.

To determine about how long the IRS takes to process corporate income tax returns before they are available for examination, we matched two IRS databases. Our match extracted 16,088 records of large corporate returns that were filed with the IRS between Calendar Years 1999 and 2002. From the 16,088 records, we determined that, on average, it is taking the IRS approximately 7 months (209 days) to process large corporate returns. Table 2 summarizes our analysis of the time periods for processing large corporate income tax returns.

Table 2: Time Periods for Processing LMSB Division Corporate Income Tax Returns

Corporate Asset Size	Number of Returns Analyzed	Range of Days	Average Days	Median Days
$10 to under $50 million	9,005	57-539	205	185
$50 to under $100 million	2,382	55-469	192	182
$100 to under $250 million	2,088	65-559	207	185
$250 million and over	2,613	65-608	241	225
Totals	**16,088**	**55-608**	**209**	**188**

Source: TIGTA analysis based on IRS data.

Because processing a return electronically eliminates all manual steps, once a return is filed it will be virtually ready for examination, thereby reducing cycle time by approximately 7 months.

Electronic filing provides complete return data to better target those returns and issues that present the greatest compliance risk

The IRS examines income tax returns to determine whether corporations and other taxpayers have voluntarily complied with tax laws and reported the proper amount of tax. To use its resources productively, the LMSB Division attempts to minimize the number of examinations that result in a no change by identifying and examining returns with the greatest likelihood of noncompliance. Minimizing no change examinations also avoids burdening compliant taxpayers who voluntarily reported the correct amount of tax.

Although LMSB Division officials have also been concerned about the number of no change IC corporate examinations, reducing the number of no change examinations remains a challenge.

In FY 2002, the LMSB Division completed 5,274 examinations of IC corporate returns and recommended approximately $1.62 billion in additional taxes. While the return on these examinations appears high (approximately $307,330 per return), the number of returns examined without any changes is still a concern. Table 3 shows that approximately 21 percent, or 1,105 of the 5,274 IC corporate returns examined, were no changes.

Table 3: FY 2002 No Change IC Corporate Examinations

Corporate Asset Size	Returns Examined	Returns No Change	Percentage of No-Changes	Examiner No-Change Hours
$10 to under $50 million	2,199	618	28%	81,480
$50 to under $100 million	735	161	22%	26,100
$100 to under $250 million	968	156	16%	25,260
$250 million and over	1,372	170	12%	33,620
Totals	**5,274**	**1,105**	**21%**	**166,460**

Source: TIGTA analysis based on Examination Program Monitoring Report, Table 37, for FY 2002.

Unlike the scoring systems used to select other corporate and individual returns, the IRS' approach for selecting IC corporate returns for examination has traditionally relied more on the experience and judgment of examiners. As a result, it is more labor-intensive and more subjective, and has shown less consistency in minimizing the number of no change examinations.

LMSB Division officials have recognized that they need a more structured system for identifying and selecting returns for examination. As discussed earlier, they have initiatives underway to improve the return selection and examination processes. However, the success of these initiatives depends on having timely access to complete return data, which has been problematic for the LMSB Division. Unlike electronic filing that will provide 100 percent of the return data, currently the IRS computers capture only 151 items on the corporate return. Large corporate returns, however, can contain thousands of items and thousands of pages.

Using complete, up-to-date electronic data to further minimize the number of examinations that result in a no change by better targeting resources to the issues that pose the greatest compliance risk could have a significant effect on tax revenues. To illustrate the potential revenue effect, we analyzed how various percentage reductions in the number of no change examinations might affect the amount of additional recommended taxes over a 5-year period. The estimates begin in FY 2005 when the 1120 *e-file* system is expected to be fully implemented and are based on the average amount of additional taxes that were recommended for each return examined in FY 2002.

Table 4 shows that when using 2002 constant dollars, the additional recommended taxes over the 5-year period ranged from $182.7 million to $914 million. The analysis in Table 4 also shows that even a relatively small 2 percent reduction in the return selection process allowed by electronic filing will return the over $33 million investment in the system in about 1 year.

Table 4: Increases in Recommended Additional Taxes Based on Percentage Reductions in No Change IC Corporate Examinations

	Percentage Reductions				
Fiscal Year	**2 percent**	**4 percent**	**6 percent**	**8 percent**	**10 percent**
2005	$34.8 million	$69.6 million	$104.4 million	$139.3 million	$174.1 million
2006	$35.7 million	$71.3 million	$107 million	$142.6 million	$178.3 million
2007	$36.5 million	$73.1 million	$109.6 million	$146.1 million	$182.7 million
2008	$37.4 million	$74.9 million	$112.3 million	$149.8 million	$187.2 million
2009	$38.3 million	$76.7 million	$115 million	$153.4 million	$191.7 million
Totals	$182.7 million	$365.6 million	$548.3 million	$731.2 million	$914 million

Source: Projections based on TIGTA analysis of Examination Program Monitoring, Table 37, for FY 2002.

Service to Large Corporations May Never Greatly Improve Unless Full Advantage Is Taken of the Opportunities Offered by Electronic Filing

Despite positive organizational changes and reengineered business processes, without the 1120 *e-file* system, a wide gap will likely remain between large corporate taxpayer expectations for efficient, modern service and the IRS' performance. While the 1120 *e-file* system is poised to close this gap and deliver other more modest benefits, such as reduced processing and storage costs, a significant barrier needs to be addressed. Specifically, there are no guarantees that the system will be used once it is available, which could be a major barrier to achieving the efficiencies offered by the 1120 *e-file* system.

Even though the project is being led by the LMSB Division, approximately 5.4 million taxpayers who filed Forms 1120 in Calendar Year 2002 are served by the SB/SE Division. Similar to the LMSB Division, the SB/SE Division could reduce taxpayer burden by receiving more accurate *e-filed* taxpayer returns and reducing taxpayer contacts to correct errors.

To remove the barrier of corporations not voluntarily using the new system, we believe that new Treasury Regulations[16] need to be initiated under Internal Revenue Code Section (I.R.C. §) 6011[17] that would require all corporations to file electronically. The regulations would ensure maximum return on the over $33 million investment in the system while potentially avoiding an estimated $1 million in FY 2004 marketing expenditures to encourage voluntary participation in 1120 *e-filing*. To date, marketing campaigns designed to encourage voluntary participation in electronic filing have had mixed results in meeting expectations of officials in both the Canada's Customs and Revenue Agency (CCRA) and the IRS.

In 1995, the CCRA began a 5-year effort to offer its estimated 1.5 million corporate taxpayers an option to file returns electronically. Canadian officials told us that their effort involved significant expense and a formal marketing strategy that included focus group testing and numerous communication products. However, only a few of the estimated 1.5 million Canadian corporations chose to use the system when it was implemented in 2000. Among the factors that hampered the popularity of the effort were advances in technology, including the growth of Internet-based transactions, and CCRA's decision to offer it as an option instead of pursuing a legislative mandate that corporations file electronically. CCRA is currently redesigning their system so taxpayers can transmit their corporate tax returns through the Internet.

Similar to the Canadian effort, the IRS has also relied on marketing campaigns to promote and encourage electronic filing since it was first introduced as a filing option in the 1980s. For 2001, the IRS spent approximately $9 million

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[16] Treasury Regulations are specific and/or technical explanations of the various sections in the Internal Revenue Code. Regulations provide guidance to both taxpayers and IRS personnel in clarifying the intent of a particular section of the tax code.
[17] I.R.C. § 6011 (1998).

on advertising to encourage individuals to file electronically. However, the number of individuals that choose to file electronically fell short of expectations. The GAO reported[18] in its assessment of the IRS' 2001 Filing Season[19] that:

> *About 31 percent of all individual income tax returns were filed electronically in 2001 – an increase of 13.7 percent compared to 2000. That rate of increase was below IRS' goal of 20 percent and lowest percentage increase since 1996. This declining growth rate occurred despite various IRS efforts to identify and eliminate impediments to electronic filing and reduces the likelihood that IRS will achieve its long-range goal of having 80 percent of individual income tax returns filed electronically by 2007.*

For 2002, the IRS spent approximately $15 million on advertising to encourage individuals to file electronically. The IRS received about 46 million individual income tax returns electronically, or about 35 percent of all individual income tax returns filed during the 2002 Filing Season. However, the Electronic Tax Administration Advisory Committee (ETAAC)[20] May 2002 report to the Congress noted that the trend of electronic filing is clearly towards lower growth rates. The ETAAC also noted that the IRS is not likely to achieve its electronic filing goals by 2007.

Although the I.R.C. prohibits the IRS from requiring individuals, estates and trusts to file electronically, there are no restrictions against requiring that corporate and other types of returns be filed electronically. To take advantage

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[18] *Tax Administration: Assessment of IRS' 2001 Tax Filing Season* (GAO-02-144, dated December 2001).
[19] The filing season is the period from January through mid-April when most individual income tax returns are filed.
[20] The ETACC is an advisory group established under the RRA 98 that ensures the Secretary of the Treasury receives input from the private sector on the IRS' plan to increase electronic filing. The group reports annually to the Congress on the IRS' progress towards meeting the electronic filing goals.

of electronic processing efficiencies, boost compliance, and increase revenue, there have been numerous regulatory changes affecting how and what needs to be reported by taxpayers on other types of returns. For example, there are regulations prescribing that partnerships with more than 100 partners must file electronically and for determining which information returns (e.g., Forms W-2 and 1099) must be filed with the IRS on electronic media. The use of electronic media enabled the IRS' Underreporter Program to more efficiently match information returns with other tax returns, which led to the assessment of $1.9 billion in additional taxes in FY 2001 and higher levels of compliance.

Recommendations

1. The LMSB Commissioner should work with the IRS Chief Counsel and the Department of the Treasury's Office of Tax Policy to determine whether requiring mandatory electronic filing for all LMSB corporations through regulations is appropriate. In the event that regulatory provisions cannot be used to make electronic filing mandatory, then these Offices should prepare a proposal for the Congress to enact legislation that requires all LMSB corporations file electronically.

   Management's Response: The IRS Commissioner stated that the IRS' top priority is to successfully develop and implement a state-of-the-art corporate e-file system with e-services, which will enable corporate taxpayers to carry out transactions directly with the IRS over the Internet. The first offering of e-services will begin with the rollout of the corporate e-file system.

   As the IRS continues to develop the e-file system, the LMSB Division will consult with the Office of Chief Counsel and the Department of the Treasury to evaluate the feasibility and impact of legally mandating corporate electronic filing.

2. The Commissioner, SB/SE Division, should complete a study as required under the Small Business Regulatory Enforcement Fairness Act of 1996[21] to determine which SB/SE corporations should be included in the mandatory 1120 *e-file* regulations and develop a plan to phase-in small corporate taxpayers.

   Management's Response: The SB/SE Division will study the feasibility of mandating electronic filing of its corporate tax returns. This study will include an internal cost/benefit analysis and external stakeholder input.

[21] The Small Business Regulatory Enforcement Fairness Act of 1996, Pub. L. No. 104-121, 110 Stat. 857 (1996), requires federal agencies to analyze the impact of new regulations on small businesses before issuance.

Appendix I

Detailed Objectives, Scope, and Methodology

Our objectives were to assess (1) the benefits of implementing an electronic filing system for large corporate taxpayers, (2) the Internal Revenue Service's (IRS) progress towards overcoming barriers to allowing large corporate taxpayers to file electronically, and (3) the implications to the IRS if the system is not successfully implemented. To meet our objectives, we relied on the IRS' internal management reports. We did not establish the reliability of these data because extensive data validation tests were outside the scope of this audit and would have required extensive resources and time.

Except as noted above, our work was conducted in accordance with *Government Auditing Standards.* Our specific audit tests included the following:

I. Consulted with officials from the United States Securities and Exchange Commission and Canada's Customs and Revenue Agency and assessed whether their experiences with information technology projects could offer insights that could be used to better ensure the IRS' efforts are successful.

II. Used the "best practices" outlined in the General Accounting Office's (GAO) *Executive Guide: Improving Mission Performance Through Strategic Information Management and Technology* to assess how well the IRS' Business Systems Modernization effort has positioned the agency to take advantage of the benefits offered by electronic filing.

III. Analyzed reports that were prepared either by or for the IRS, including a consulting firm's study, to identify the benefits, costs, risks, and barriers to implementing the electronic filing system.

IV. Participated in meetings with internal and external stakeholders and reviewed the project's plan documentation to assess the progress made against the cost and schedule developed for implementing the electronic filing system.

V. Analyzed the steps and amount of time taken to process 16,088 large corporate returns that were filed with the IRS between Calendar Years 1999 and 2002 to determine the impact electronic filing may have in reducing examination cycle time. We derived the 16,088 corporate tax returns by matching the taxpayer identification numbers and tax periods from an extract of the Statistics of Income Automated Return Tracking System (STARTS) containing 49,556 records with the Fiscal Year (FY) 2002 Audit Information Management System (AIMS). The STARTS extract contained data about large corporate tax returns that the Statistics of Income (SOI) Division sampled, processed, and released during FY 2002. The AIMS file provided the dates when tax returns were filed with the IRS. By analyzing the two databases we determined the time period to process

16,088 corporate tax returns from the date the tax returns were filed with the IRS until the returns completed SOI processing.

VI. Analyzed results from 5,274 large corporate examinations that were closed in FY 2002 to determine the impact electronic filing may have on reducing the number of examinations that result in a no change. The 5,274 examinations represent the entire universe of examinations for corporations with assets of $10 million or more as reported on the Examination Program Monitoring Report, Table 37, for FY 2002.

VII. Interviewed IRS officials who are either involved with or affected by electronic filing to obtain their opinions about the agency's modernization efforts, including how electronic filing will better meet the needs of large corporate taxpayers while ensuring their compliance.

VIII. Reviewed information related to electronic filing, including reports issued by the GAO, Treasury Inspector General for Tax Administration, and Electronic Tax Administration Advisory Committee, to assess the implications to the IRS if electronic filing does not meet expectations.

IX. Reviewed the Internal Revenue Code and Treasury Regulations to determine if there were any restrictions against the IRS requiring large corporations to file electronically.

Appendix II

Major Contributors to This Report

Richard Dagliolo, Acting Assistant Inspector General for Audit (Small Business and Corporate Programs)
Philip Shropshire, Director
Frank Dunleavy, Audit Manager
Lisa Stoy, Senior Auditor
Richard Turner, Senior Auditor

Appendix III

Report Distribution List

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Taxpayer Burden – Potential; 5.5 million corporate taxpayer accounts affected annually (see page 1).

Methodology Used to Measure the Reported Benefit:

According to the Internal Revenue Service's (IRS) Data Books, approximately 5.5 million corporate taxpayers filed U.S. Corporation Income Tax Returns (Forms 1120) and U.S. Income Tax Returns for S Corporations (Forms 1120S) in Calendar Year (CY) 2002. The benefits of mandating that these returns be filed electronically include greater assurances that (1) all tax returns are mathematically accurate, (2) all information on the returns is accurately posted to accounts in IRS records, and (3) all tax returns are available for examination sooner because of reduced processing time. More accuracy and faster processing means potentially fewer contacts with these taxpayers to correct errors and shorter cycle time if their returns are selected for examination, which have been identified as burden issues by either the IRS or its external stakeholders.

Type and Value of Outcome Measure:

- Increased Revenue – Potential; $182.7 million in additional recommended taxes over 5 years based on a 2 percent reduction in the no change rate for Industry Case (IC) Corporate Examinations (see page 6).

Methodology Used to Measure the Reported Benefit:

To estimate the increased revenue, we analyzed how various percentage reductions in the number of no change IC corporate examinations might affect the amount of additional recommended taxes over a 5-year period beginning in Fiscal Year (FY) 2005 when the system is expected to be in place. In estimating the additional taxes each year, we started with the average amount of additional taxes that were recommended for each IC corporate return examined in FY 2002 according the IRS' Examination Program Monitoring, Table 37. Next, we multiplied the average FY 2002 recommended additional taxes by the Consumer Price Index inflation conversion factors to determine the value of 2002 tax dollars in 2005 through 2009. Our final step involved multiplying the converted FY 2002 recommended additional taxes by the number of returns associated with the various percentage reductions in the number of no change examinations.

We found that the amount of additional recommended taxes that could be generated over a 5-year period ranged from $182.8 million to $914 million, depending on whether a 2, 4, 6, 8, or 10 percent reduction in no change examinations is achieved. However, we conservatively limited the benefit to the additional recommended taxes that could be generated with a 2 percent reduction in the number of no change IC corporate examinations.

Type and Value of Outcome Measure:

Funds Put to Better Use – Potential; $1 million that may be spent encouraging corporations to voluntarily file electronically in FY 2004 (see page 12).

Methodology Used to Measure the Reported Benefit:

To estimate the potential funds that could be put to better use by requiring corporate taxpayers to file electronically, we allocated the approximately $18 million that the IRS is planning to spend for its FY 2004 *e-file* marketing activities among the individuals that have not filed electronically in the past, corporations, and other business taxpayers. In allocating the potential dollars that may be spent encouraging corporations to file electronically, we followed a five-step process.

First, we used the Calendar Year Return Projections for the United States and IRS Centers: 2001-2008 (Document 6186, December 2001) to determine the total number of individual (131,991,400) and business taxpayers (11,498,300) who filed tax returns with the IRS in CY 2002. Second, we calculated the percentage of business taxpayers among the population of total taxpayers (business and individual), excluding the number of individual taxpayers already filing electronically (47,384,913 or 35.9 percent). Third, we multiplied the $18 million budgeted for FY 2004 marketing activities by the percentage of business taxpayers (11.96 percent) and arrived at $2.1 million. We performed this calculation because the IRS provided us the total FY 2004 *e-file* marketing budget figure but was unable to further divide the total budget figure into marketing dollars allocated specifically to individual and business taxpayers. Fourth, we used the number of corporate taxpayers (5,495,800) from Document 6186 and calculated the percentage of corporate taxpayers among the population of business taxpayers. Fifth, we applied this percentage (47.80 percent) to the $2.1 million to determine the estimated $1 million that could be put to better use.

Appendix V

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

RECEIVED
MAY 19 2003

May 19, 2003

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Mark W. Everson
Commissioner of Internal Revenue

SUBJECT: IRS' Response to Draft Audit Report – New Regulations Are Needed to Take Full Advantage of the Opportunities Offered by Filing Large Corporate Income Tax Returns Electronically (Audit # 2002-30-005)

I agree with your assessment of the actions the IRS has taken to ensure a successful implementation of electronic filing for corporate tax returns, and its potential benefits for corporate taxpayers and the IRS. The 1120 e-file system we are developing will have the capacity to accept corporate income tax returns filed by small and large corporations. The IRS' Small Business/Self Employed (SB/SE) Division serves approximately 5.4 million corporations and the Large and Mid-Size Business (LMSB) Division serves approximately 76,000 corporations that will have the option to file Forms 1120 and 1120S electronically.

Implementation of the corporate e-file system will change the way we receive, process, store, and retrieve taxpayer information. It will significantly reduce the filing burden of corporations served by the SB/SE and LMSB divisions, while providing a system permitting taxpayers to directly communicate and transact electronically with the IRS.

I attached a detailed response on the corrective actions we will take to address your recommendations and our opinion on your estimated outcome measures.

If you have any questions, please contact David H. Bass, Director, Business Systems Planning (LMSB Division) at (202) 283-8610 or Robert L. Hunt, Director, Taxpayer Education and Communication (SB/SE Division) at (202) 283-2627.

Attachment

Attachment

IDENTITY OF FINDINGS AND RECOMMENDATIONS:

FINDINGS:

- The IRS has taken significant actions to overcome barriers that could hamper the success of electronic filing for large corporations.
- Electronic filing is poised to reduce lengthy examinations and deliver other benefits.
- Service to large corporations may never greatly improve unless full advantage is taken of the opportunities offered by electronic filing.

RECOMMENDATION 1:

The Commissioner, LMSB Division should work with the IRS Chief Counsel and the Department of Treasury's Office of Tax Policy to determine whether requiring mandatory electronic filing for all LMSB corporations through regulations is appropriate. If the LMSB Division and Chief Counsel cannot use the regulatory provisions to make electronic filing mandatory, then these offices should prepare a proposal for the Congress to enact legislation that requires all LMSB corporations file electronically.

CORRECTIVE ACTIONS:

The system we are building for the electronic filing of corporate returns is unusually challenging for two reasons. First, the complexity of our tax laws requires that corporate taxpayers file many detailed forms that we have to convert to an electronic format. Converting these forms is time-consuming and exacting. Second, the corporate e-file system will use extensible markup language (XML), an Internet programming language. We are using this technology in a major application for the first time. Therefore, we need to carefully test the system to ensure it meets our business needs.

We also want to provide a substantial number of services electronically. Our top priority is to successfully develop and implement a state-of-the-art corporate e-file system with e-services, which will enable corporate taxpayers to carry out transactions directly with the IRS over the Internet. Our first offering of e-services will begin with the rollout of the corporate e-file system.

As we continue to develop our e-file system, we will consult with the Office of Chief Counsel and the Department of Treasury to evaluate the feasibility and impact of legally mandating corporate electronic filing.

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IMPLEMENTATION DATE:

Proposed: May 1, 2004

RESPONSIBLE OFFICIAL(S):

LMSB Division Counsel (Chief Counsel)
Deputy Director, International (LMSB)

CORRECTIVE ACTION(S) MONITORING PLAN:

The responsible officials will send periodic status updates to the Inventory Tracking and Closure System Report Coordinator in the LMSB Division (Management and Finance) to report on the progress of the corrective actions.

RECOMMENDATION 2:

The Commissioner, SB/SE Division should complete a study, as required under the Small Business Regulatory Enforcement Fairness Act of 1996, to determine which SB/SE corporations should be included in the mandatory 1120 electronic filing regulations and develop a plan to phase-in small corporate taxpayers.

CORRECTIVE ACTION:

The SB/SE Division will study the feasibility of mandating electronic filing of its corporate tax returns. This study will include an internal cost/benefit analysis and external stakeholder input.

IMPLEMENTATION DATE:

Proposed: May 1, 2004

RESPONSIBLE OFFICIAL(S):

Director, Taxpayer Education and Communication (SB/SE)

CORRECTIVE ACTION(S) MONITORING PLAN:

The responsible officials will send periodic corrective action status updates to the Inventory Tracking and Closure System Report Coordinator in the SB/SE Division (Management and Finance) to report on the progress of the corrective actions.

OUTCOME MEASURES:

We cannot agree with the outcome measures on Appendix IV of your report without an assessment of the impact of electronic filing on corporate returns (Forms 1120 and 1120S). It is impossible to state the monetary benefits until we analyze at least a sample of the corporate electronic returns.